Special Issues For Nonprofit Employers: Financial Relationships With Executives And Other Organizational Insiders



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INTRODUCTION

Nonprofit organizations share many or most employment issues commonly faced by for-profit businesses. In addition to those issues, however, there are a few areas in which a nonprofit employer's tax-exempt status plays an important role in defining the nonprofit's relationships with its employees, and may require approaches that are completely distinct from those used by the employer's for-profit counterparts. Undoubtedly among the most important of these areas is an exempt organization's financial dealings with executives and other employees who have substantial influence over the operations of the organization.

The Internal Revenue Service pays careful attention to these financial relationships, and has recently undertaken efforts to increase transparency with respect to compensation and benefits paid by tax-exempt organizations, most notably in the redesign of the Form 990 information return. The IRS's concern, in all cases, is that the compensation represents no more than a fair and reasonable payment for the services that are rendered to the tax-exempt organization. The rest of this outline will discuss in more detail the source of and rationale for this substantive requirement, the procedures that tax-exempt organizations can and should use to establish the presumption that payments to these employees and insiders are, in fact, reasonable, and the penalties for making payments that give undue benefit to certain employees and other organizational insiders.

A. PROHIBITION ON PRIVATE INUREMENT

To retain tax-exemption, an organization must be organized and operated so that "no part of its net earnings inures to the benefit of any private shareholder or individual." IRC § 501(c)(3). A "private shareholder or individual" is a person having a personal and private interest in the activities of the organization as opposed to a member of the general public. The burden is on the organization to establish that it is not organized and operated for the benefit of private interests—the organization's activities must be broad enough in scope to confer a public benefit, as opposed to benefiting only insiders.

Section 501(c)(3) of the Internal Revenue Code (the "Code") provides for loss of exempt status in the case of any private inurement. Despite this explicit prohibition on "inurement," the term is not defined in the Code or the Treasury Regulations. It is clear, however, from the development of case law and Revenue Rulings issued by the IRS that private inurement results when an insider (whether an individual or an entity) takes from a charitable organization's earnings in some way that unfairly benefits the insider.

There is nothing in Code Section 501(c)(3) that prohibits dealings between a charitable organization and its insiders—so long as those dealings are at arms' length, conducted in good faith, and on terms that are reasonable. For example, an organization may pay its founder a reasonable fee for services the founder renders to the organization without private inurement resulting. It is only when the interests of the charity are sacrificed to the private interests of the insider that inurement occurs.

In general, an organization cannot be exempt if it engages in private inurement. However, in 1996, Congress enacted Code Section 4958 to impose penalties short of revocation in the form of excise taxes—so-called *intermediate sanctions*—in those cases where an excess private benefit does not rise to a level where it calls into question the organization's charitable status. These penalties come in the form of excise taxes imposed on the organizational insider (in the language of Code Section 4958, "disqualified persons") and any organization managers who approved payments to the insiders knowing that they were excessive. The presence of intermediate sanctions does not mean that the IRS may not propose revocation in addition to, or instead of, intermediate sanctions in cases where excess benefits to insiders rise to an egregious level.

B. TAXES ON EXCESS BENEFIT TRANSACTIONS

1. Overview of Code Section 4958

Intermediate sanctions apply to excess benefit transactions between applicable tax-exempt organizations and "disqualified persons," or organizational insiders. The sanctions can be imposed on both the disqualified person who receives an excess benefit and organization managers who knowingly approve it.

Code Section 4958 imposes an initial tax on the disqualified person who was the recipient of an "excess benefit" from an exempt organization in the amount of 25% of the value of the excess benefit. IRC § 4958(a)(1). The "excess benefit" is the amount received by the disqualified person in excess of fair market value. *See* IRC § 4958(c)(1) (defining "excess benefit transaction"). In addition to the excise tax, the disqualified person is required to "correct" the excess benefit transaction—that is, repay the amount of the excess benefit to the organization, including interest. Treas. Reg. § 53.4958-7(c). If the transaction resulting in the excess benefit is not corrected before the 25% tax is assessed, a second-tier tax of 200% of the amount of the excess benefit will apply. IRC §4958(b). If the disqualified person corrects the excess benefit within the "correction period"—within 90 days of receipt of a notice of deficiency from the IRS—then the 200% tax will be abated, and the 25% may be abated in the discretion of the Director of Exempt Organizations at the IRS. *See* IRC § 4963(e); Treas. Reg. § 53.4963-1; Internal Revenue Manual 7.27.30.7.

In addition to the tax on the disqualified person, Section 4958 imposes a tax of 10% of the amount of the excess benefit (up to a maximum of $20,000 per transaction) on organization managers—officers, directors, or trustees—who allowed the organization to engage in the transaction knowing it was an excess benefit transaction. IRC §§ 4958(a)(2) & 4958(d)(2). An organization manager's reasonable reliance on the advice of a professional that a transaction will not result in an excess benefit will ordinarily allow the organization manager to avoid liability for the 10% tax. Treas. Reg. § 53.4958-1(d)(4)(iii).

If the disqualified person or the organization manager engaged in the excess benefit transaction without reasonable cause to believe that the transaction would not result in an excess benefit, and either (1) such persons were previously liable for excise taxes under Section 4958; or (2) such persons' actions were both willful and flagrant, an additional penalty equal to the amount of the excise taxes will apply. IRC § 6684.

If more than one person is liable for the tax on either the disqualified persons or the organization managers as a result of an excess benefit transaction, then they are all jointly and severally liable for the tax. IRC § 4958(d)(1).

2. Key Definitions Regarding Section 4958 Taxes

a. Disqualified Person

There can be no excess benefit transaction without a disqualified person. A disqualified person is any person in a position to exercise *substantial influence* over the affairs of the organization at any time during the five-year period ending on the date of the transaction involved. IRC § 4958(f)(1). The definition of disqualified person also includes members of such person's family, and an entity in which such a person owns more than a 35% interest. *Id.*

i. Persons Having Substantial Influence

The Regulations provide that a person who holds any of the following powers or responsibilities is in a position to exercise substantial influence over the affairs of a tax-exempt organization, and is thus a disqualified person:

- Directors (voting members of governing body)
- President, Chief Executive Officer, Chief Operating Officer (responsible for implementing decisions of governing body or supervision management of entity)
- Treasurer, Chief Financial Officer

Treas. Reg. § 53.4958-3(c).

ii. Facts and Circumstances Tending to Show Substantial Influence

Other persons not specifically identified above may nevertheless be disqualified persons because they are deemed to have substantial influence over the organization. Factors tending to demonstrate substantial influence include:

- The person is the founder of the organization
- The person is a substantial contributor (over 5% of revenue in any one year) to the organization
- The person's compensation is based on revenues of the organization, or of a department or piece that the individual controls
- The person has authority to control or determine a substantial portion of the organization's capital expenditures, operating budget or employee compensation
- The person manages a discrete portion of the business that represents a substantial portion of the activities, assets, income or expenses of the organization

Treas. Reg. § 53.4958-3(e)(2).

iii. Facts and Circumstances Tending to Show **No** Substantial Influence

Some other persons may not be disqualified persons because of facts and circumstances that demonstrate they do not in fact exercise substantial influence over the organization. Factors tending to show a lack of substantial influence include:

- The person has taken a vow of poverty
- The person is a contractor (attorney, accountant, etc.) whose sole relationship to the organization is providing professional advice
- The person's direct supervisor is not a disqualified person
- The person does not participate in management decisions

Treas. Reg. § 53.4958-3(e)(3).

b. Applicable Tax-Exempt Organizations

Taxes on excess benefit transactions (intermediate sanctions) apply only when the transaction involves an applicable tax-exempt organization. Section 4958(e) defines such organizations to include:

- 501(c)(3) public charities (but not private foundations)

- 501(c)(4) social welfare organizations
- Government entities are excepted

c. Excess Benefit Transactions

An excess benefit transaction is any transaction in which an economic benefit is provided to a disqualified person if the value of the economic benefit exceeds the value of the consideration received by the organization. IRC § 4958(c)(1).

Examples of Excess Benefit Transactions

(1) Excessive compensation—including benefits paid. Note that if benefits paid are not accounted for as compensation, they are *automatically* determined to be excessive (an "automatic excess benefit," discussed below in Section D).

(2) Payment by an exempt organization of greater than fair market value for assets in a transaction.

(3) Receipt of less than fair market value for goods or services provided by the exempt organization.

(4) Revenue sharing arrangements which violate the private inurement prohibition, *i.e.*, sharing of net revenue.

C. DETERMINING REASONABLE EXECUTIVE COMPENSATION— THE REBUTTABLE PRESUMPTION PROCEDURE

1. The Requirement of Reasonable Executive Compensation

The prohibition on private inurement means that any transactions with disqualified persons, including executives, must be carefully reviewed and determined to be "reasonable" to ensure that no private inurement is created. The most common situation in which private inurement may arise is in the payment of unreasonable compensation to disqualified persons.

Reasonable compensation is the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances. Treas. Reg. § 4958-4(b)(1)(ii). Compensation includes "all economic benefits provided by an applicable tax-exempt organization in exchange for the performance of services." *Id*. As a result, the value of all economic benefits provided to an insider in exchange for the performance of services must constitute the amount that would ordinarily be paid for similar services by a similar organization.

The most useful tool an organization can use to comply with the private inurement rules is to follow the so-called rebuttable presumption procedure when establishing the compensation for organization insiders. If the following requirements as to a compensation arrangement with a disqualified person are satisfied, the reasonableness of payments made under such arrangement is *presumed*. The Internal Revenue Service may rebut the presumption of reasonableness only if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body. Treas. Reg. § 53.4958-6(b).

2. Establishing the Presumption of Reasonableness

Payments under a compensation arrangement between an exempt organization and a disqualified person are presumed to be at fair market value if the following conditions are met:

(a) The compensation arrangement is approved in advance by an "authorized body" of the applicable tax-exempt organization which is composed entirely of individuals who do not have a "conflict of interest" with respect to the compensation arrangement;

(b) The authorized body obtained and relied upon "appropriate data as to comparability" prior to making its determination; and

(c) The authorized body "adequately documented the basis for its determination" concurrently with making that determination.

Treas. Reg. § 53.4958-6(a). Each of these conditions is discussed below.

a. Authorized Body Free from Conflicts of Interest

"Authorized body" includes the governing body, a committee of the governing body, or other parties authorized under state law and by the governing body to act on its behalf by following procedures specified by the governing body in approving compensation arrangements. Treas. Reg. § 53.4958-6(c)(1). An individual is not considered to be included in the "authorized body" for these purposes if the individual meets with other members only to answer questions, and otherwise recuses him or herself from the meeting and is not present during debate and voting on the compensation arrangement. *Id.*

Under Minnesota law, a nonprofit corporation may establish committees having the authority of the board in the management of the business of the corporation by the affirmative vote of a majority of the board. Minn. Stat. § 317A.241. The authority of such committee is as set forth in the resolution creating such committee.

The members of the authorized body must also be free from "conflicts of interest" with regard to the compensation at issue. A member does not have a conflict of interest if the member:

- Is not the disqualified person economically benefiting from the compensation arrangement, and is not a family member of any such disqualified person
- Is not in an employment relationship subject to the direction and control of any disqualified person benefiting from the compensation relationship
- Does not receive compensation or other payments subject to approval by the disqualified person being compensated
- Has no material financial interest affected by the compensation arrangement
- Does not approve a compensation package to any person who in turn has approved or will approve a compensation arrangement for the member

Treas. Reg. § 53.4958-6(c)(1)(iii).

b. Appropriate Data as to Comparability

The organization must do more than merely use an appropriate group of people to determine the compensation for disqualified persons. The Regulations make it clear that the organization must also consider and rely on appropriate comparative data. This is because "reasonable" compensation is defined to mean compensation for services in an "amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances." Treas. Reg. § 53.4958-4(b)(1)(ii). This standard is satisfied if "given the knowledge and expertise of its members, it has information sufficient to determine whether the compensation arrangement in its entirety is reasonable." Treas. Reg. § 53.4958-6(c)(2).

Relevant information includes, but is not limited to, compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the availability of similar services in the geographic area of the organization; current compensation surveys compiled by independent firms; actual written offers from similar institutions competing for the services of the disqualified person. For small organizations—those with annual gross receipts of less than $1 million—the Regulations allow for establishing comparability by relying

on internal, informal surveys of compensation levels for similar services paid by as few as three comparable organizations in the same or similar communities rather than independent surveys and consultant reports. Treas. Reg. § 53.4958-6(c)(2)(ii).

The facts and circumstances to be taken into consideration in determining reasonableness of compensation are those existing on the date the parties enter into the contract pursuant to which the obligation is fixed and payable. Treas. Reg. § 53.4958-4(b)(2). A payment may be considered "fixed and payable" for these purposes where the amount or formula is fixed in a contract, even if an amount is payable only upon the occurrence of future events or contingencies, provided that no person exercises discretion when calculating the amount of payment or deciding whether to make a payment. Treas. Reg. § 53.4958-4(a)(3). This means, for example, that an escalator clause in a contract calling for annual increases in the compensation amount based on the Consumer Price Index will not cause a contract to be other than "fixed" for purposes of establishing the presumption. *See* Treas. Reg. § 53.4958-4(a)(3), *Example 1.*

Where a payment is not made fixed and payable under a contract, reasonableness is determined based on all of the facts and circumstances as of the date of payment. Treas. Reg. § 53.4958-4(b)(2). The rebuttable presumption may be established only after the exact amount of the payment is determined or a fixed formula for calculating the payment is specified. Treas. Reg. § 53.4958-6(d)(1).

c. Concurrent Documentation of the Basis for Determination

Finally, in order to establish the presumption, the authorized body must adequately document its reliance on appropriate comparability data. The authorized body is determined to have adequately documented the basis for its decision if the written or electronic records (i.e., the minutes) of the authorized body include the following:

- The terms of the transaction that was approved and the date of approval;
- The members of the authorized body who were present during the debate on the transaction and those who voted on it;
- The comparability data obtained and relied upon by the authorized body and how the data was obtained; and
- Any actions taken with respect to the consideration of the transaction by anyone who had a conflict of interest with regard to the transaction.

Treas. Reg. § 53.4958-6(c)(3). For the documentation in the minutes to be considered "concurrent" with the approval of the transaction, they must be prepared before the later of the next meeting of the authorized body or 60 days after final approval, and the authorized body must review the and approve the minutes as being reasonable, accurate, and complete within a reasonable time after the meeting. *Id.*

D. STRATEGIES FOR COMPLIANCE

All 501(c)(3) and 501(c)(4) organizations should strive to use the "rebuttable presumption of reasonableness" process described above when approving any financial arrangements or transactions with disqualified persons, including compensation arrangements. The rebuttable presumption procedures are in effect required, as evidenced by an IRS "Governance Check Sheet" released in December 2009. The Check Sheet, which is to be used by IRS agents in the course of evaluating the governance of tax-exempt organizations under audit, identifies numerous practices which the IRS considers to be problematic, and prominently includes the failure to follow rebuttable presumption procedures. Furthermore, the burden-shifting that results from properly following this process is extremely effective in discouraging further action by the IRS when it does conduct an audit, to the point that the rebuttable presumption procedure creates a virtual safe harbor for compensation decisions arrived at through use of the procedure.

Establishing the presumption, however, requires both advance planning and proper recordkeeping. For example, an organization is likeliest to use an "authorized body free of conflicts of interest" in its executive compensation decisions if it has, as an initial matter, created an effective conflicts of interest policy which the organization adheres to and calls to the attention of its insiders on at least an annual basis.

The organization will also want to create and maintain clear records of the data it relied on and the basis for its decision. In doing so, the organization's decision-making body should keep thorough minutes when it is approving compensation packages or other payments to its disqualified persons. When striving to create the type of record necessary to meet the rebuttable presumption, an organization should not be shy about including detail. For example, even if the organization's habit for documenting its decisions on other items of business is to simply recite the decision in the minutes, when establishing the rebuttable presumption it is best to also document the discussion. It is not necessary to include a verbatim transcript or to identify which board members said what, but it would be appropriate and desirable to include statements such as, "The Board engaged in a vigorous discussion regarding the base salary for Disqualified Person X. During the discussion, the point was raised that DQ'd Person X exceeded all of the annual goals set for her by the board," and so on.

If the authorized body decides to award compensation to a disqualified person that is in the upper ranges of the comparable data the board reviews and relies on, it will be all the more important to include detail in the minutes to justify its decision. Relevant specifics

regarding the organization's particular situation and the disqualified person's accomplishments should be included.

It is also generally a good idea to keep these records permanently. This is important given the severe penalties for a finding of excess benefit, and given that there is no statute of limitations on the IRS's ability to propose revocation of an organization's tax-exempt status.

Finally, it is important for 501(c)(3) and 501(c)(4) organizations to be aware of **automatic excess benefit transactions**. In general, any payment of value from an applicable exempt organization can be an excess benefit transaction unless it is a sale or other transfer of property at fair market value, reasonable compensation for services, or certain disregarded payments such as working condition fringe benefits and payments under an "accountable plan" (i.e., a reimbursement or other expense allowance arrangement that meets the requirements of Treas. Reg. §§ 1.62-2(d)–(f)). Treas. Reg. § 53.4958-4(c)(1). In order for a payment to be treated as reasonable payment for services, *an organization must establish a clear intent to treat the benefit as compensation at the time the benefit is paid. Id.* The Regulations provide that any payments that are not either payments for property or payments excluded from Section 4958 will be *automatic excess benefit transactions* absent a clear intent to treat them as compensation. *Id.* at 4(c)(2). Note that under this rule, such payments will be automatically deemed "excessive" even if the total payments to the disqualified person would not be more than reasonable compensation for the services provided. Reimbursements—such as those made for cell phones or PDAs—when they are not made under an accountable plan, are frequent automatic excess benefit transaction pitfalls. Other forms of payments that can be problematic for organizations include the value of below-market rate loans and severance payments.

The cleanest way for an organization to avoid trouble with excess benefit transactions is to treat *all* payments to its disqualified persons as compensation. If it does, the organization's written, contemporaneous substantiation of its intent to treat the applicable payments as compensation will take the form of a report on Form W-2 or Form 1099. The organization should also report the payments on its Form 990 Information Return, and the disqualified person who receives the payment should report it on his or her Form 1040. All such written, contemporaneous substantiation, of course, must be made before the IRS commences an audit or provides notice of a potential excess benefit. Treas. Reg. § 53.4958-4(c)(3)(i)(A).

E. PENALTIES FOR NONCOMPLIANCE

As discussed in Section B.1 above, the penalties for engaging in excess benefit transactions include excise taxes payable by the disqualified person who received the benefit, as well as any organization managers who knowingly participated in the transaction. All of the recipients of the excess benefit and all of the organization managers who participated in the excess benefit transaction are jointly and severally

personally liable for the excise taxes and additional penalties (for repeat offenders or "willful and flagrant" violations).

While the organization's status is not at issue in the assessment of intermediate sanctions, it is important to keep in mind that if an organization participates in a particularly egregious excess benefit transaction, or in a pattern of excess benefit transactions, the organization's exempt status could also be at risk of revocation.

For all taxable years beginning on or after July 31, 1996, applicable exempt organizations are required to report on their Form 990 any excess benefit transactions entered into or discovered in that tax year, unless the excess benefit was timely corrected. IRC § 6033(b)(11)-(13). Similarly, disqualified persons and organization managers subject to the tax must pay the tax and file Form 4720 annually. Treas. Reg. 53.6071-1(f)(1).

Despite the stiff penalties for excess benefit transactions under Code Section 4958, the abatement of the 200% second-tier tax and the possible abatement of the 25% first-tier tax when an excess benefit transaction is corrected is meant to encourage the reporting and correction of these transactions. Moreover, attempting to avoid the excise taxes imposed under Section 4958 can be very costly. Penalties for failure to file or for signing or assisting in the preparation of a false or fraudulent return include maximum fines of between $10,000 and $100,000 and potential imprisonment (depending on the specific offense) for individuals, and between $50,000 and $500,000 for corporations. *See* IRC §§ 7201–7207.